Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:3:FTL:TL-POSTS-107116-02
JTLortie

date: Mar 3 2002

to: Pamela Breault, Estate Tax Attorney

from: JOHN T. LORTIE
Senior Attorney (SBSE)

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subject: **Advisory Opinion -** [redacted]

This is in response to your recent request for our views regarding the gift of a partnership interest made by the above taxpayer.

ISSUE

Whether the donor may make a gift of a portion of his limited partnership interest equal to a fixed value and then later retroactively change the percentage of the partnership interest given as part of the completed gift due to the fact that he undervalued the amount of the gift?

CONCLUSION

No, the donor may not later change the fractional amount of the partnership interest once he has made a completed gift of a specific partnership interest. The fact that he later discovers that the fractional interest he gave as a gift is undervalued does not allow him to change the gift since he released all dominion and control over that portion of his partnership interest. To permit him to subsequently change the gift would violate public policy as discussed more fully in the Procter case and its progeny.

FACTS

The donor entered into various Assignment Agreements on [redacted] in which he assigned a portion of his limited partnership interest in [redacted], Ltd., a [redacted] limited partnership, to his children. The partnership is a family limited partnership created in [redacted] and consists of various [redacted], [redacted] and [redacted].

The gift assignments consisted of "defined value" gifts in which the donor ascribed a specific value to the gift. The Assignment Agreements contained the following language:

[redacted]

An appraisal was subsequently done which determined that the $[redacted] gift equaled a [redacted]% interest in the partnership. The taxpayer subsequently identified this percentage interest as a gift of $[redacted] on his gift tax return for the [redacted] tax year. You are now determining whether the gift should be adjusted since the fair market value of a [redacted]% interest in the partnership is probably worth more than $[redacted].

You anticipate that the taxpayer's representative will argue against continuing the examination of this gift issue by stating that if the partnership interest is subsequently determined to be worth more than $[redacted], then the taxpayer will simply change the percentage interest in the partnership for gift tax purposes. The representative contends that this will not cause any gift tax adjustment. You are now requesting our advice as to whether the taxpayer may later change the fractional amount of the partnership interest once he has made a completed gift of a specific partnership interest and whether there would be a taxable gift under the circumstances of this case.

DISCUSSION

A gift tax is imposed upon "the transfer of property by gift." I.R.C. §2501(a)(1). The gift tax applies to transfers of both real and personal property, including interests in limited partnerships such as in this case. I.R.C. §2511. The amount of the gift is the value of the property as of the date of the gift. I.R.C. §2512(a). Treas. Reg. §25.2512-1 states that "The [fair market] value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell...."

In this case, the threshold issue is whether the assignment of partnership interests was made for adequate consideration as part of a business arrangement. Under Tres. Reg. §25.2512-8, a sale exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent) will be considered as made for adequate and full consideration in money or money's worth. In the present case, the transfers appear to be entirely gratuitous made by a parent to his adult children and step-children with all active participation in the decision making and management of the partnership business remaining with the donor. Thus, it appears that the assignment of the partnership interests in this case were in fact gifts subject to gift tax.

Once we have determined that the transfers of the partnership interests were gifts, we need to determine what exactly was given as a gift in this case. The Assignment Agreements provide for a transfer of a partnership interest equal to $[redacted] as of [redacted]. The donor subsequently had an appraisal done of the partnership and filed a gift tax return in which he stated that a [redacted]% interest was equal to $[redacted] as of the [redacted]. The donor has identified the gift as a [redacted]% fractional interest in the partnership. If it is subsequently determined that this interest is worth more than $[redacted], then there will be a gift of the difference.

The donor cannot simply change the gift if it is later determined that the partnership interest he gave away is worth more than the $[redacted] that he intended. This would be contrary to public policy as discussed in the case of Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944). In Procter, the taxpayer assigned his interest in two trusts to a third trust for himself and his children. The assignment agreement contained a "savings clause" which provided that if the transfer was subsequently determined by a court or by judgment to be subject to gift tax, then the excess would remain the sole property of the taxpayer. In effect, the donor would be making a gift of the property and then regain possession of any of the excess which was subject to gift tax, thus making a "savings" to the donor of the excess amount.

The court found that this "savings clause" violates public policy for three reasons: 1)it tended to discourage tax collection because if the Service audited the gift and determined that there was an excess, the gift of the excess amount would be defeated; 2) it obstructed justice by requiring the court to determine a moot issue since if it determined that there was a gift tax, the donor could simply regain possession of the property; and 3) it would cause a final judgment of the court to

be meaningless since there would be no gift once a judgment is entered stating that the excess gift was subject to gift tax.

In the present case, if the donor were allowed to change the gift after the appraisal was made, the gift would violate public policy as stated in Procter since the gift would not be complete. This is similar to the transaction in Ward v. Commissioner, 87 T.C. 78 (1986) in which the parents made gifts to their sons who signed an agreement that if the value of the stock for gift tax purposes was determined to be greater than the value set forth in the agreement, the number of shares of stock would be adjusted so that the value of the gift equaled the amount fixed in the agreement. The court held that such an agreement violated public policy since it allowed the parents to revoke a part of the gift, leaving the excess value of the gift to pass to the sons without ever being taxed. The court noted that once a completed gift is made, the donor relinquishes all dominion and control over the property and may not later change the gift. See also, Treas. Reg. §25.2511-2. The same is true in this case.

Similarly, the Service has challenged gifts of property where the amount of property transferred is defined in the transfer document solely as based upon fair market value (known as formula clauses). For example, in TAM 8611004, the Service held that a series of assignments of limited partnership interests conveying fractional interests equal to a specific value were not determinative of the actual interest conveyed by the donor/decedent. The Service ruled that a valuation of the partnership had to be made at the time of each assignment in order to determine the amount of the gift.

These types of gifts dealing with formula clauses have also been challenged by the Service in FSA 200122011 (2-20-01), 2001 TNT 107-17 and the [redacted] which is currently pending before the Tax Court

We note that the gift in the present case is distinguishable from the gift in King v. United States, 545 F.2d 700 (10th Cir. 1976) in which the 10th Circuit Court of Appeals upheld a savings clause that did not attempt to revoke the transaction (unlike in the Procter case). In King, the taxpayer established trusts for the benefit of his children with his lawyer as trustee. He then sold the stock of his corporation to the trusts, retaining the stock as security for payment of the purchase price. The four trusts then executed notes for $2,000,000.00 based on a price of $1.25 per share. Simultaneously, the taxpayer and the trustee of the trusts entered into four letter agreements which stated that if the IRS determines the fair market value of the stock to be different than $1.25 per share, then the purchase price will be

adjusted to the fair market value as determined by the IRS. The Service later determined that the stock was worth $16.00 per share and determined a gift tax liability on the value of the stock in excess of the face value of the notes (i.e., $14.75 per share). The trusts did not make any adjustment of the purchase price after the IRS determined the fair market value of the stock.

The trial court found that the taxpayer intended that the trusts pay full consideration at whatever price the IRS ultimately determined to be the fair market value of the stock. Also, the court relied upon the fact that the transaction was lacking in donative intent and was done at arm's length in the ordinary course of business. Here, the gift of the partnership interests appears to have been gratuitous and not in the ordinary course of business. Thus, the King case is distinguishable from the facts of the present case.

Finally, we note that while we agree that a gift exists in this case and that a valuation of the partnership interest needs to be done as of the date of the gift, the interest in a family limited partnership may be subject to valuation discounts for lack of marketability and lack of control. See Estate of Dailey v. Commissioner, T.C. Memo. 2001-263 (40% Discount allowed for Gifts); Estate of Strangi v. Commissioner, 115 T.C. 478 (2000), appeal pending (31% Discount allowed). Thus, even though the gift in this case may be taxable, you may conclude that an appropriate discount rate may apply thereby reducing the amount of the taxable gift.

Our office continues to be available to assist you in the development of this case. If you need any further assistance or if you have any questions, please call John T. Lortie of our office at [redacted]. We are now closing our file subject to reopening if further assistance is needed.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

JOHN T. LORTIE
Senior Attorney (SBSE)

NOTED:

KENNETH A. HOCHMAN
Associate Area Counsel (SBSE)